Capital Markets Monitor

Dec'02/Jan'03

Financial Attaché's Office
U.S. Embassy Moscow

HIGHLIGHTS

- Draft Code for Auditors pending with MinFin
- Russian Depository Receipts under development
- Indexed mutual funds, Eurobond funds introduced
- 2002 stock market review

REGULATORY UPDATE

Amendments to Law "On the Securities Market" in force

On December 28, 2002, President Putin finally signed the amendments to the law "On the Securities Market," which entered into force on January 4, 2003. Experts view these amendments as the most significant development to this law since its adoption in 1996. The amendments increase protection of investor's rights by improving transparency, regulating activities of professional market participants, and control over price manipulation. However, the Presidential administration believed that the original set of amendments passed by the Duma this fall gave too much discretionary power to the FCSM and the President vetoed the law on this basis (See CMM Sept.-Oct.2002). The Duma Deputies revised the amendments and, as a result, the FCSM was deprived of the authority to determine on which shares margin trading will be allowed, to set the requirements for share listings on stock exchanges, and to determine requirements for accreditation of financial consultants. Instead, these requirements are specified in the amendments, with the FCSM acting only as regulator. The amendments also require issuers of ADRs or other placements by Russian issuers of securities abroad to obtain an FCSM permit, but new revisions detail the conditions under which the FCSM can issue such permits.

Amnesty for 75% of joint stock companies

Registration of pre-1996 share issues with the FCSM is one of the most difficult problems in Russian securities markets today. According to Goskomstat data, 4.3 million joint stock companies are operating in Russia, but only 1.1 million have properly registered their share issues with the FCSM. This is because the law "On the Securities Market" was passed in 1996, and did not cover any of the enterprises established during the period of mass privatization in the early 1990s. (A government resolution "On issuance and circulation of shares on the stock exchanges," issued at the end of 1991 required registration, but companies either didn't know about it or thought that it did not apply to them.) As a result, over 75% of Russian public joint-stock companies fall into this category and have not registered their shares at the FCSM. Further, many simply have refused to register, preferring to pay a nominal fine to the FCSM and, in some cases, declining to register the next issuance, ostensibly to avoid oversight and the costs of registration. While this situation may prove detrimental to the companies themselves (for example, banks might refuse to lend to them), it increases risks for all shareholders because at any time the companies' shares transactions can be declared null and void by the courts.

Accordingly, the Moscow Duma Deputies (where the majority of such companies are located) proposed a draft law that was subsequently passed by the State Duma in a first reading in November 2002. The law requires companies to register paper issuance (shares, corporate bonds) with the FCSM within one year or they will be liquidated. The FCSM commented that the amount of work should not be too burdensome, both because the registration procedures will be simplified and because almost 50% of the violating companies exist only on paper. However, in early December, lawyers from the Presidential administration commented that the process of legalization proposed in the draft is not workable as they violate the rights of some participants. Companies whose issues have been declared void by the court and those which do not have such a court decision would be put in an unequal position. Duma Deputies have already started to rework the draft law with the help of the FCSM and NAUFOR to avoid such conflicts. Hopefully early consultations will help avoid a Presidential veto similar to the amendments to the law "On the Securities Market."

Periodic dividends addressed again

As was reported in the Sept.-Oct.'02 CMM, new amendments to the law "On Joint Stock Companies" have come into force which will formally allow companies to pay periodic dividends. In practice, many of the large companies already pay periodic dividends (quarterly in most cases), which are proposed by the board of directors and approved by the shareholders. However, the new amendments state that the decision on such dividends can be made only by an extraordinary shareholders meeting (EGM). For large companies such as Gazprom with 500,000 shareholders, it would cost approximately $1 million to hold a meeting with three to four months advance preparation time. Since the current procedures seem to work, large companies view EGMs as a waste of time and money.

In response, the Ministry of Economy and Development proposed further amendments to the law "On JSC" which would allow the BoD to approve a company's dividend policy without an EGM. While large corporations welcome this proposal, there are some underlying problems. It's no secret that in some cases, the BoD is biased toward the majority shareholder/shareholders, and some minority shareholders would not want to lose the right to change company dividend policy. The problem could be solved by allowing shareholders to decide whether they want to grant such powers to their board.

Code for Auditors

The FCSM has developed a draft Code for Auditors and forwarded it to the Finance Ministry for the consideration, as MinFin is the body that regulates auditors. This Code would be a voluntary set of rules and behaviors that would be adopted by the auditing profession in Russia. The FCSM became concerned about potential auditing problems in Russia early in 2002 after the Enron bankruptcy, and also after Gazprom minority shareholders complained about malfeasance by Gazprom's auditor, Pricewaterhouse Coopers. The FCSM gathered representatives of Big-4 and Russian auditors at the end of February 2002 to discuss ways to prevent such problems in Russia, but at that time the auditors were not ready to make any concrete proposals. As a result, the FCSM took the initiative by forming an expert group to develop the Code. Some professional organizations, such as Institute of Professional Auditors, have already stated that they are willing to recommend that their members adhere to the Code. Even though the Code for Auditors is voluntary, the hope is that most professionals would follow the Code to maintain their reputations.

A future for Russian depository receipts?

The idea of Russians investors buying foreign stocks through issuance of Russian Depository Receipts (RDRs) first arose after the 1998 Financial Crisis, as a number of investment vehicles lost attractiveness. In 1999, a working group was created to address the issue, but did not produce any result. Recently, however, the FCSM resurrected the idea and, with the Central Bank of Russia, plans to develop the normative base for Russian Depository Receipts, which could be launched presumably in 2003/04. RDRs would help deepen Russian domestic capital markets and give market players, including institutional investors such as state and non-state Pension Funds and insurance companies, another tool to diversify risk. The Central Bank and MinFin would likely approve of this plan, as money allocated for purchases of foreign assets through RDRs would stay in Russia, rather than leaving for international exchanges. Foreign participation in the market through RDRs would also promote healthy competition between domestic and foreign securities, which could stimulate Russian public firms to be more transparent and continue improvements in corporate governance. The timetable for introduction in 2003 seems fairly optimistic, however, given the complex legal and tax issues that need to be worked out.

CAPITAL MARKET EVENTS

Slavneft privatization - fair market valuation?

The results of the sale of the government's stake in Slavneft were predictable (See CMM Sept.-Oct.'02). The events leading up to the auction fit together like pieces of puzzle, revealing the only favorite of the sale. Sibneft, in cooperation with TNK, already owned around 24% of Slavneft though affiliated companies. The combination of the two companies owned blocking shares in the two most important subsidiaries of Slavneft. Moreover, Sibneft had bought out the Belorussian's government stake of 10.83% in Slavneft just a week before the auction. This was enough for the leading Russian oil companies to take back their requests to participate in the auction. The Chinese National Oil company also withdrew its participation request under the pressure of other Russian officials from the State Duma, who were concerned about foreign ownership of a key strategic asset. As there was no real competition, the government's 75% stake in Slavneft was sold for $1.86 billion, about half of the previously-projected $2.5 billion. The price received by the privatization was intended to indicate how far Russia had come since the fire-sales of the mid-1990's, and this is probably a fair barometer -- much closer to market value but probably not the maximum if it had been truly a competitive market. While Russian senators have demanded an investigation into their conclusion that the Russian budget was deprived of around $1 billion, there is little likelihood of nullifying the results of the auction. The next test of corporate governance in this case will be the valuation of Slavneft assets and how Sibneft and now BP/TNK will share control over these assets.

LUKoil: state shares sold, maximum price gained

The Russian state sold its 5.9% stake in LUKoil at the beginning of December 2002 for the highest price ($15.5/share) it could possibly gain at that time. The proceeds to the budget were $775 million, which were credited to financial reserves for payment of external government debt falling due in 2003. The sale had been scheduled for August, but the government at the last moment refused to go forward with the auction because of unfavorable market conditions. It turned out to be a wise decision: if the shares had been sold in summer, the revenues would have been $71.5 million lower. The high price was most likely due to good financials of the company. Also, LUKoil announced its intentions to participate in the Slavneft auction and apparently began to gather its resources to do so, which was perceived very positively by market players and share prices rose as a result. However, there were rumors that the company never intended to participate in the auction and the statement was made with the sole purpose to push up the price before the sale of the government's stake. A case of price manipulation would likely be difficult to prove.

Mutual funds market - new funds introduced

On December 22, the FCSM registered the first indexed mutual fund in Russia for PioGlobal Asset Management (formerly Pioneer Asset Management, one of the oldest such firms in Russia). The fund will invest in Russian stocks based on the MICEX index. This index was chosen for a reason: its capitalization-weighted index is calculated using 18 shares of 12 leading issuers, 65% of which are shares of the major oil companies. The high minimum investment required indicates that the fund is geared towards wealthier investors. To attract clients, the company lowered its management fee to 0.5%, making total client fees not more than 1%. PioGlobal has announced that it plans to organize a secondary market for the shares of the fund on MICEX to make the investment more liquid and flexible for fund clients. Currently, shares can be bought/sold four times a year, once at the end of each quarter.

At the same time, Troika Dialog announced the creation of the first fund in Russia that will invest in Eurobonds. According to the current law "On currency regulation and currency control," only banks with a general license or external economic activity participants can trade Eurobonds - the rest must obtain permission from the CBR for each transaction. Therefore, such potential Eurobond investors such as Russian insurance companies, non-state pension funds and private individuals have had no opportunity to invest in this asset class. After over a year of negotiations, recently Troika obtained extended permission from the CBR to trade Eurobonds with no limitations. Some market players attributed Troika's success to the fact that two Deputies of the current CBR Chairman previously worked at the company. However, the market praised Troika for the initiative, as perhaps the barrier is now broken and other companies can develop similar products. Insurance companies have already expressed interest Troika's new fund, so the demand seems to be there. Some expect the CBR to issue soon general instructions on the procedure of investment into the Eurobonds by asset-management companies. The FCSM has been supportive of the new initiative, noting that the number of funds and management companies is continually increasing.

Mutual Fund Trading begins

The RTS launched secondary trading in mutual fund shares in late January 2003 and MICEX plans to start in late February. This was made possible upon completion in late 2002 of several regulatory acts. The FCSM then approved the MICEX and RTS trade rules. Circulation of secondary shares will make closed-end and interval mutual funds more attractive as it increases liquidity by allowing clients to enter and exit the fund at will. More importantly, secondary trading will broaden the geographic range of the client base for mutual funds. Currently, one of the problems of mutual funds is the lack of a regional network, but if shares are traded on stock exchanges, any regional broker registered with the exchange can purchase them for his or her clients. Market players have welcomed this long-awaited event and many funds have already confirmed that they are getting ready to introduce secondary trading of their shares. Secondary trading should serve an additional impetus for even more rapid growth of mutual funds (see Moscow Financial Weekly for Nov.1, 2002).

IPO consultants set up shop

In January 2003, the RTS, Pricewaterhouse Coopers, and Clifford Chance announced the opening of a free consulting center or "RTS listing point" for companies interesting in issuing IPOs. It is designed to advise managers on strategies for issuing shares on either Russian (mainly) or external markets, including information on different financial instruments as well as listing requirements for various stock exchanges. Investment banks' representatives have characterized the initiative as useful, as the Center will help clarify the process for issuers, and at this stage do not see the Center as a competitor. The RTS anticipates that at least 200 clients will visit the Center. The Center will especially be useful for medium-sized companies, which have little experience in public share issuance. (See below for more on IPOs.)

THE RUSSIAN STOCK MARKET IN 2002

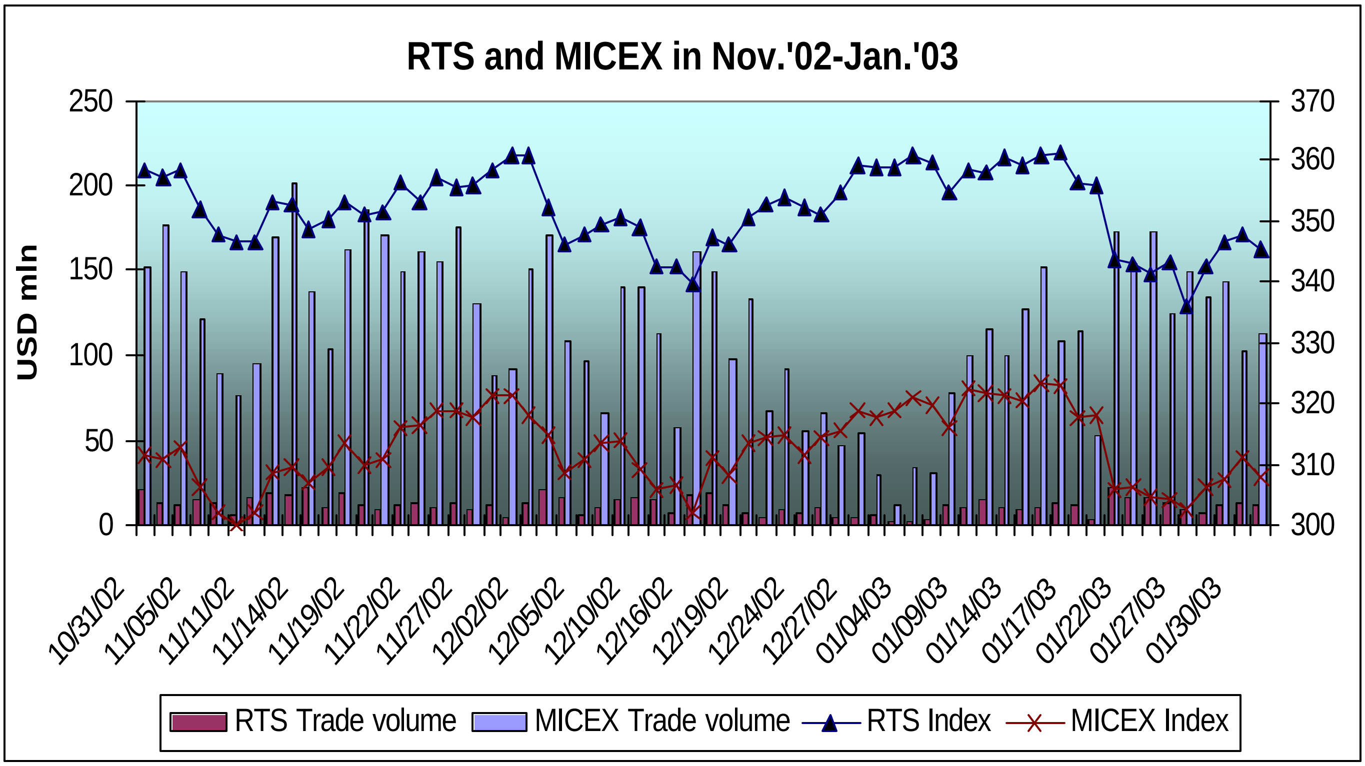
The stock market has continued to develop in 2002, with the benchmark RTS index increasing by 38.1%, ending the year as the second best performing market in the world after Pakistan. This is the third year of continuous growth, helped by a continued global slump and continued political and economic stability in Russia. Arguably, the rate of growth was slower than in 2001 (82.76%), but still compares favorably to its world counterparts.

While oil prices were the main reason for this bull market, other more subtle trends contributed as well. Shares for Sibneft (gaining 195%) and YUKOS (80% increase) reflected significant improvements in corporate governance, as well as good (transparent) financials and increased production. Consolidation of the telecoms sector led to increased investor attention to these shares. RAO UES was one of the worst performers, dropping 22% in value, showing volatility throughout the year due to the uncertainty over the power generation sector's long-delayed restructuring.

Spreads between common and preferred share prices continued to narrow last year. The increase in the price of preferreds was more than that of common shares in almost every case where a company had these two kinds of shares circulating on the market. This phenomenon has several explanations. Previously, companies tended not to pay dividends in most cases and had no dividend policies, so preferreds exhibited no financial advantage to investors over common shares. Currently, however, trade has increased as preferred shares have a 10% claim on annual profits, as stipulated in their charters, making them a more attractive investment. Prices on preferreds may be growing also due to the growing practice of swapping preferred shares for common shares. Some companies don't like paying the 10% premium to preferred shareholders, so to save money they developed programs of swapping the preferreds into common shares. Investors may be buying preferred shares, with the intention that they will be swapped into common shares of the company. (Surgut might be the next candidate for this kind of swap. Its method of computing net income was detrimental to preferred minority shareholders, but pending changes in the law will establish rules which will force Surgut to increase the amount of income available for paying dividends.)

Several expectations in the market have not been realized last year, however. Players anticipated that foreign money would enter the Russian market in force in 2002 after such impressive growth in 2001; however, this year instead featured more Russian money in the market. Domestic investors helped the market to rally in the first half of the year, and then supported the somewhat lower growth levels achieved during the second half of 2002. Unfortunately, the market did not rally at the end of the year as expected, most likely due to world political tensions.

The year was been momentous for the Russian stock market in one other aspect as well. While many chose to finance their investment needs through Eurobond issues, others also turned to the domestic capital markets as a source of raising funds through IPOs. Last year Rosbusinessconsulting (RBC) made a successful placement, selling 16% of its shares and raising $16 million for new projects. The pharmacy chain "36.6" followed, selling 20% of its shares for $14.4 million in January. Wimm-Bill-Dann, went further, issuing an IPO in New York that raised $238 million. It became the third Russian firm to conduct an IPO abroad before a domestic stock issue (Vimpelcom raised $100 million this way in 1996, and MTS $371 million in 2001). While these are important trends, the Russian stock market is still very narrow, as can be seen from the total volume of funds raised of around $700 million. However, most observers agree that with continued economic growth, both domestic and external IPO programs will gradually grow in number.



Explanatory notes

ADR - American Depository Receipt

AGM – Annual shareholders' meeting

ARM - Association of Russian Managers

CBR – Central Bank of Russia

DCC - Depository Clearing Company

EGT – Extraordinary Shareholders' meeting

FCSM – Federal Commission on Securities Market

GDR - Global Depository Receipt

ICLG - Institute of Corporate Law and Governance

IPA - Investors' Protection Association

MICEX - Moscow Interbank Currency Exchange

NAUFOR - National Association of the Capital Market Participants

NFA - National Capital Market Association

PARTAD - Professional Association of Registrars, Transfer Agents and Depositories

RTS - Stock Exchange "Russian Trading System"

SGQ - RTS System of Guaranteed Quotes

MMC Norilsk Nickel - Mining &Minerals Company Norilsk Nickel

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